

Selling Your Home Tax Free

Most homeowners know that when they sell their primary residence, it is very unlikely that they will have to pay any tax on the sale proceeds if their home has appreciated in value. This is due to the 1997 change to Section 121 of the Internal Revenue Code (“IRC”) that allows a single person to exclude from taxation up to \$250,000 of appreciation (\$500,000 if you are married and file jointly) on the sale of their primary residence. On December 24, 2002, the Department of the Treasury finally issued the new regulations that explain how this change in the law should be applied.

In order to qualify for this exclusion, you must have owned and used the home as your primary residence for at least two out of the last five years.¹ If the home is owned in trust, the beneficiary of the trust will be considered as the owner so long as the trust qualifies as a “grantor trust” under IRC §§671 through 679.² Additionally, if the home is owned by a disregarded entity under Treasury Regulation §301.7701-3, it will be treated as being owned by the owner of the entity.³

If you alternate between two homes, the Internal Revenue Service (the “Service”) will look at the number of days in which you used each home as your residence during the year to determine whether or not the property sold qualifies as your primary residence. Since you can have only one primary residence during any given year, the home in which you spent the majority of your time will be considered as your primary residence for that year.⁴ If you take short vacations away from home, the Service will still count those days towards the total number lived in the home.⁵ Additionally, if you move to a nursing facility, so long as you used the home for at least one year during the previous five, the gain can still be excluded under IRC §121.⁶ However, days spent away from home on long sabbaticals or extended, temporary job relocations will not be counted.⁷ This could present a problem for military personnel or corporate executives who have extended overseas postings and who also maintain a home in the U.S.

A second requirement is that you could not have used the exclusion within the two years immediately before the sale.⁸ This rule prevents taxpayers from living in one house for two years, then moving into a second home for the next two years, and then selling both homes in the fifth year and excluding the gain on both sales. Under those circumstances, the gain could be excluded on only one sale. To exclude the gain on both sales, you must sell only the first home in year five, and then wait two years to sell the second home.

With our mobile society, taxpayers were worried about what would happen if they sold their home before living in it for two years. If the reason for the sale was simply because you like to move around, and if your home had appreciated enough within that short period of time so you had a gain (after deducting closing costs and realtor fees), then you will have to pay capital

¹ Treasury Regulation §1.121-1(a).

² Treasury Regulation §1.121-1(c)(3)(i).

³ Treasury Regulation §1.121-1(c)(3)(ii).

⁴ Treasury Regulation §1.121-1(b)(2).

⁵ Treasury Regulation §1.121-1(c)(2)(i).

⁶ Treasury Regulation §1.121-1(c)(2)(ii).

⁷ Treasury Regulation §1.121-1(c)(4), Example 4.

⁸ IRC §(b)(3).

gain taxes. However, if your early move was prompted by (1) a change of employment to a new job that is at least 50 miles away from the old home,⁹ (2) a change in health supported by a doctor's recommendation to move,¹⁰ or (3) "unforeseen circumstances," defined in new Treasury Regulations as (a) disasters, (b) death, (c) losing a job making one eligible for unemployment compensation, (d) divorce, (e) multiple births resulting from the same pregnancy, and (f) under other facts and circumstances the Service determines to be "unforeseen," you could still exclude a portion of the gain.¹¹

Although you could qualify under these exceptions, the amount of the exclusion is reduced if you have not used the home as your primary residence for two years. The maximum exclusion amount is reduced by a fraction, the numerator of which will usually be the number of days or months the property was used as the principal residence, the denominator of which is either 730 days or 24 months, depending on the measure of time used in the numerator.¹² For example, if you only used the home as your primary residence for twelve months, you can only exclude one-half of the maximum amount (\$125,000 for singles/\$250,000 married filing jointly). Since most residences do not appreciate in value this quickly, the loss of a portion of the exclusion should not be a significant concern.

Another common concern is whether tax can be excluded when there has been a sale of vacant land that adjoins the personal residence. So long as the residence is also sold within two years of the sale of the vacant land, the sales are treated as one transaction for purposes of IRC §121, and the gain on both sales can be excluded.¹³ The sale of the residence can happen two years before, or after the sale of the vacant land; however, if the vacant land is sold first, the taxpayer must initially report the gain and pay the tax on that gain for that year. When the residence is later sold, the taxpayer can go back and amend the prior return to exclude the gain on sale of the vacant land and request a refund.¹⁴

Finally, there will usually not be a problem with the surviving spouse "losing" \$250,000 worth of exemption if a spouse dies the home is sold shortly thereafter. If the sale of the home appears on the couple's final joint return, the \$500,000 exclusion would still apply.¹⁵ However, assuming the home was owned equally in both names, when a spouse dies, one-half of the value of the house will receive a step-up in basis, permanently eliminating the gain on one-half of the value of the home. This means that even though the surviving spouse only has her single exemption left, unless the home had appreciated by more than \$500,000 at the time of the first spouse's death, there should be no tax. In fact, if the home had appreciated more than \$500,000 at the first spouse' death, the step-up in basis would eliminate more gain than the IRC §121 exclusion. The surviving spouse would be in a worse position only if there was substantial appreciation after the first spouse's death.

⁹ Treasury Regulation §1.121-3T(c)(2)(ii).

¹⁰ Treasury Regulation §1.121-3T(d)(2).

¹¹ Treasury Regulation §1.121-3T(e).

¹² Treasury Regulation §1.121-3(g).

¹³ Treasury Regulation §1.121-1(b)(3).

¹⁴ Treasury Regulation §1.121-1(b)(3)(C).

¹⁵ Treasury Regulation §1.121-4(a).